

Evolving Spaces in the Wake of the Pandemic: Vulnerabilities from the Commercial Real Estate Sector

Globally, the commercial real estate (CRE) sector has been impacted by the pandemic, as movement restrictions adversely affected economic activity and the demand for commercial property. The world also experienced pivotal shifts in working and spending patterns. These will likely have a lasting impact on how future physical spaces are utilised, particularly office and retail commercial spaces. In many countries, the size of the CRE sector, its heavy reliance on debt funding, and strong interconnectedness with the real economy make the CRE sector a potential source and amplifier of risk to financial stability. Adverse shocks such as the recent COVID-19 pandemic can negatively impact CRE prices and the financials of CRE borrowers. This in turn increases risk to lenders, and reduces investments into CRE, with knock-on effects on the financial sector and real economy. Such issues are less pervasive in Malaysia, given that the size of the CRE market and its direct linkages to the financial system are smaller than most other countries.¹

This article comprises three sections. The first section explores key structural trends observed in the CRE sector, including examples of how industry players globally and locally are adapting to the changes. The second section examines the various conceptual linkages that exist between the CRE sector and financial sector, including those beyond direct credit exposures to the banking system. The article then concludes with a discussion on the potential implications for financial stability and the broader economy in Malaysia.

Recent structural trends in the commercial real estate market

The CRE sector, like many others, has seen pivotal shifts brought on or accelerated by the pandemic, many of which will likely continue well after the health crisis recedes. Globally, three structural trends are notable: a greater shift towards flexible working arrangements, the accelerated pace of digital transformation, and an increased focus on health and safety.

While the pandemic has accelerated the adoption of flexible working arrangements, it has not removed the need for office spaces altogether. Various workplace surveys indicate the continued need and desire for employees to return to the office for at least part of the week when movement restrictions ease. According to a survey on office worker preferences,² 81% of Malaysian office workers believe the workplace will continue to be vital, at least in the short term. This reflects the importance attached to social interactions in physical settings which continue to be a key aspect of office life in Malaysia. Office spaces will thus need to be able to accommodate hybrid working arrangements and evolving needs of tenants, with flexible space and design features for emerging work patterns. This entails investing in tools, technologies and infrastructure that would allow effective remote working. These demands are likely to further reduce the appeal of older buildings compared to newer buildings equipped with more modern and sophisticated infrastructure. In major cities such as London and Singapore, old office buildings are increasingly being re-purposed in response to changing tenancy needs, with some buildings converted into dwellings and art centres. While this process has been going on for some time before the pandemic, it has been further accelerated by the effects of the pandemic.

The rise of e-commerce is also expected to transform, rather than replace, the role of physical shopping malls. In Malaysia, online retail trade activity grew on average by 18.4% in 2021,³ with e-commerce expected to nearly double its current share of total retail sales within the next two years.⁴ Retailers and mall owners have responded to this shift by pursuing omni-channel retailing and offering convenience services as they strive to balance the high-touch shopping experience that consumers desire, against their need for a safe and efficient shopping experience. More retailers are also re-configuring their physical presence in malls to offer a

¹ For many European countries, direct lending to the CRE sector comprised on average a third of total bank lending to businesses in 2019, reaching higher than 50% in the United States and Estonia (Source: International Monetary Fund, 2021).

² Savills Survey published in November 2021. Survey respondents comprised 50% non-managerial, 40% managerial and 10% senior management.

³ See Chapter 1 of the Economic and Monetary Report 2021.

⁴ E-commerce comprised 7% of total retail sales in 2020 and is forecasted to grow to 12% by 2023 (Source: Euromonitor and eMarketer).

novel and more immersive experience,⁵ in order to maintain their appeal to customers who have become more accustomed to shopping online.

Physical distancing norms have also rapidly transformed the way people inhabit and interact in physical spaces. Measures that promote safety, health and wellbeing introduced during the pandemic have become the new norm, particularly for commercial spaces with high footfall such as shopping malls, offices, and hotels. This is likely to stay even after the lifting of restrictions. Safety-conscious tenants and visitors will increasingly seek spaces that pay careful attention to hygiene and sanitisation procedures and are equipped with the requisite facilities. A survey of Malaysian office workers reveals that 70% of respondents place high importance on cleanliness and 69% on air quality to be comfortable in a workplace.⁶ Commercial building owners have begun incorporating designs that promote contactless access, such as facial recognition, hands-free doors, and touch-free elevator systems. Regular deep cleaning of premises and UV disinfection systems are also among the more visible changes introduced in many commercial spaces to attract and retain tenants, as firms increasingly strive to provide a safe working environment for their employees and visitors.

Financial stability risks from the commercial real estate sector

Historically, CRE markets have posed major risks to the balance sheets of financial institutions, playing an amplifying role in financial crises globally. This was the case in Sweden in the 1990s, as well as in countries such as Ireland and the United States during the 2007-2009 Global Financial Crisis, where disorderly adjustments in CRE prices contributed to financial stress.⁷

In general, risks to financial stability posed by the CRE sector have been observed to be more significant than the housing market.⁸ Three key factors contribute to this. First, lending to the CRE sector is typically concentrated in loans for construction and development, which tends to be riskier than loans to purchase properties (i.e., end-financing). Given the large scale of commercial development projects, financing for such projects can be sizeable, commonly involving syndication across multiple banks. If such loans are improperly structured or monitored, the failure of a single project could lead to significant losses upon default and potentially affect multiple lenders simultaneously. Second, construction periods are inherently longer for commercial developments compared to residential projects.⁹ This can result in situations where a temporary increase in rentals for commercial spaces prompts construction that outstrips the underlying demand, creating an oversupply that takes longer for the market to absorb. Third, default probabilities for CRE loans can be more cyclically sensitive compared to housing loans. Like housing markets, evidence suggests that CRE markets are closely intertwined with business cycles.¹⁰ During an economic downturn, however, borrowers in the CRE sector have less incentive to avoid default compared to housing loan borrowers, who tend to be predominantly owner-occupiers.

Developments in the CRE sector can also affect the financial system through the collateral channel. Borrowers, specifically businesses, pledge properties they own as collateral to obtain bank financing. When the market value of the CRE asset increases, businesses can access more loans while maintaining the same financing margin. Conversely, a sudden price decline in the CRE collateral could increase potential losses to banks in the event of default.

⁵ Examples include malls that feature more indoor recreational activities (e.g., skating rink, rock climbing gym) and retailers offering 'experience concierge' or social media-ready photo backdrops and on-demand personal stylists to enhance the retail experience.

⁶ Source: Savills Survey (November 2021).

⁷ See Englund (1999), Ellis and Naughtin (2010), and Olszewski (2012).

⁸ The difference in impact during the Global Financial Crisis was particularly apparent in the United States, the United Kingdom and Ireland, where CRE prices fell by 20-30 percentage points more than house prices. For a more in-depth discussion of the contributing factors, see Ellis and Naughtin (2010).

⁹ This is common in Malaysia, as the construction of commercial buildings is not required by law to be completed within a specified period, unlike residential projects (e.g., 2 years for landed residential properties).

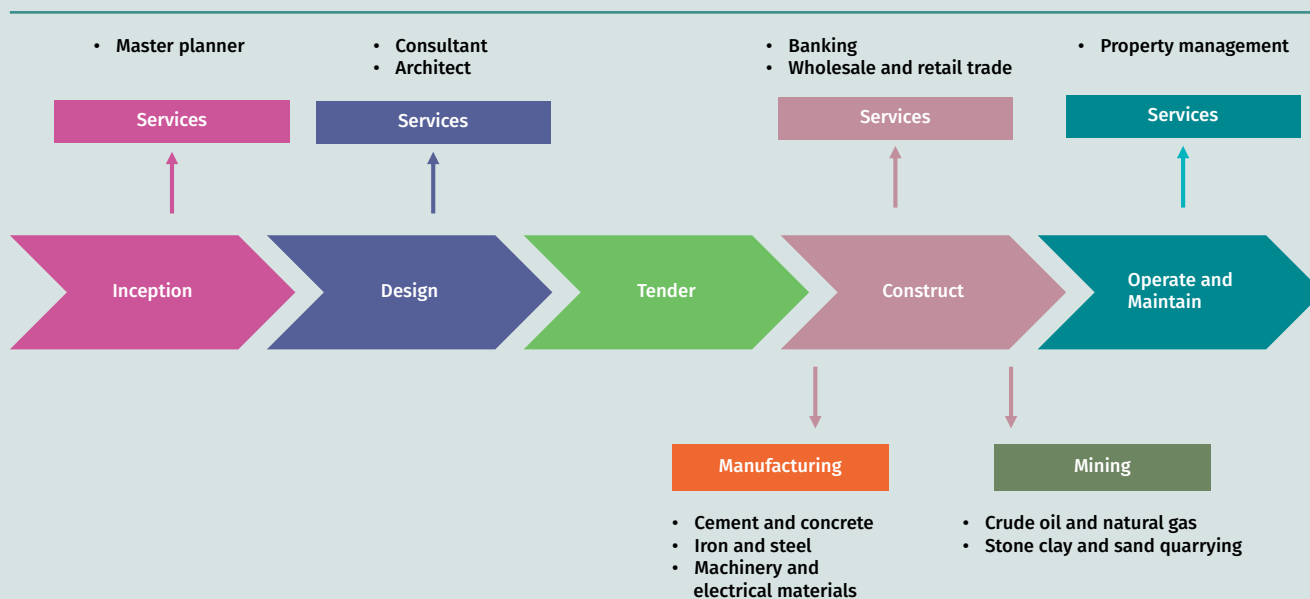
¹⁰ See the European Systemic Risk Board's 'Report on commercial real estate and financial stability in the EU' (2015).

Risks to financial stability can also arise from transmission channels between the CRE sector and the financial system which are less direct.

First, commercial and residential real estate share common production factors such as land and building materials. Therefore, prices in one property segment are likely to influence values in the other property segment, especially within the same location. Thriving commercial spaces also add value to, and improve property values in surrounding neighbourhoods, as residents can benefit from proximity to amenities typically offered by retail spaces.¹¹ Conversely, it can be inferred that prolonged weaknesses in commercial properties may weigh on the prices of other surrounding properties and affect future house prices in the vicinity.

Second, the share of CRE to construction sector value-added accounted for 11% in 2021 (0.4% of GDP). While the construction sector only constitutes a small share of the overall Malaysian economy (2021: 3.7% of GDP), it is highly integrated with other economic sectors through both backward and forward linkages. These linkages have the potential to create high multiplier effects to the economy. More specifically, the manufacturing, services and mining sectors are key segments within the CRE supply chain, where construction of CRE relies heavily on inputs from these related industries (Diagram 1). As such, a slowdown in CRE activity would not only affect the construction sector, but also activities across other related industries.

Diagram 1: Illustration of Primary Level Value Chain of the Construction Industry



Source: Bank Negara Malaysia and Construction Industry Development Board

Third, the construction sector and its related industries also play a significant role in creating employment opportunities for both the skilled and unskilled workforce. This is especially true in Malaysia, where the number of workers employed in the construction and real estate sectors remain sizeable, comprising 9% and 7.3% of total workers, respectively, as at the fourth quarter of 2021.¹² In the event of a shock to the CRE sector, a deterioration in employment and income conditions could adversely impact the ability of affected workers to service their debt. A recent study conducted by the Department of Statistics, Malaysia found that employees in the construction sector and real estate services were among those particularly affected during the pandemic, with slightly over half of respondents employed in these sectors suffering a decrease in monthly income due to the pandemic.

¹¹ See Kam et al (2015) and Sale (2015) for case studies on the impact of locational attributes to house prices in Mukim Rawang, Malaysia and South Africa, respectively.

¹² Source: Department of Statistics, Malaysia.

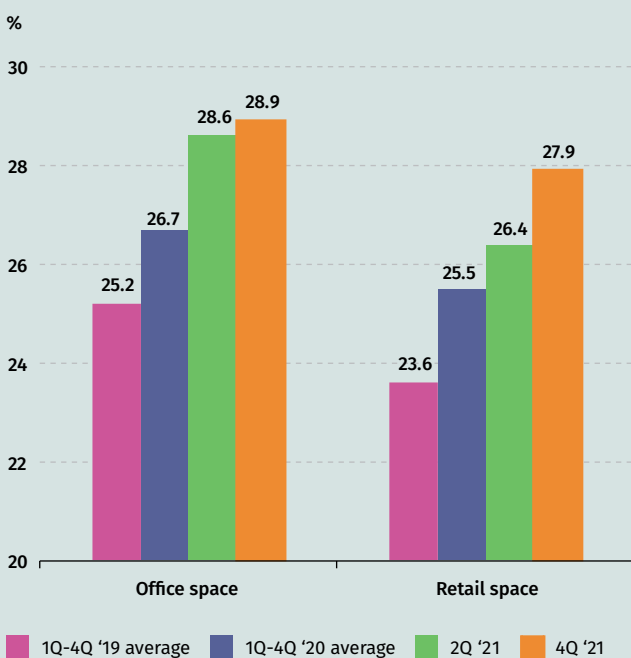
These indirect transmission channels can lead to a broader deterioration in banks' asset quality arising from exposures to businesses in industries related to the CRE sector, residential property lending and households that are employed across the supply chain.

Implications of post-pandemic structural trends on financial stability

In Malaysia, post-pandemic structural trends are likely to add to pre-existing imbalances. Vacancy and rental rates have worsened since the onset of the pandemic (Chart 1) and could take longer to improve given the structural shifts observed.

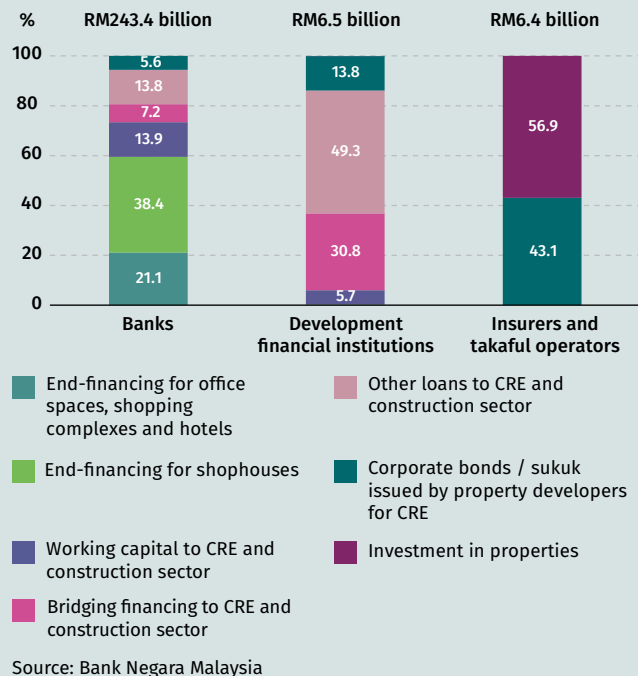
Direct linkages between the CRE sector and the financial system are, however, limited thus substantially mitigating risks to financial stability. Relative to many countries,¹³ linkages between the CRE sector and the financial system are significantly lower in Malaysia, with credit exposures to the CRE sector comprising 7.8% of total banking system assets. The share of CRE exposures to overall property exposures of financial institutions has declined in the past decade, reflecting banks' cautiousness towards the sector. The largest share of bank exposures to CRE is in the form of end-financing for the purchase of shophouses (Chart 2). Historically in Malaysia, trends for shophouses typically follow developments in the housing market, which makes shophouses more resilient relative to other CRE segments, further mitigating financial stability risks.¹⁴ The quality of overall bank lending to the sector is also sound, with impairment ratios remaining low at 1.5%. The share of Stage 2 loans has risen to 12% (June 2021: 9.4%), in line with an expected deterioration in asset quality as a result of COVID-19 developments. This increase, however, to some extent reflects conservative loan staging and provisioning practices of banks during the pandemic in view of continued uncertainty in the credit outlook.¹⁵

Chart 1: Vacancy Rates for Office and Retail Space in Klang Valley



Source: Jones Lang Wootton

Chart 2: Financial Institutions' Exposures to the CRE Sector



Source: Bank Negara Malaysia

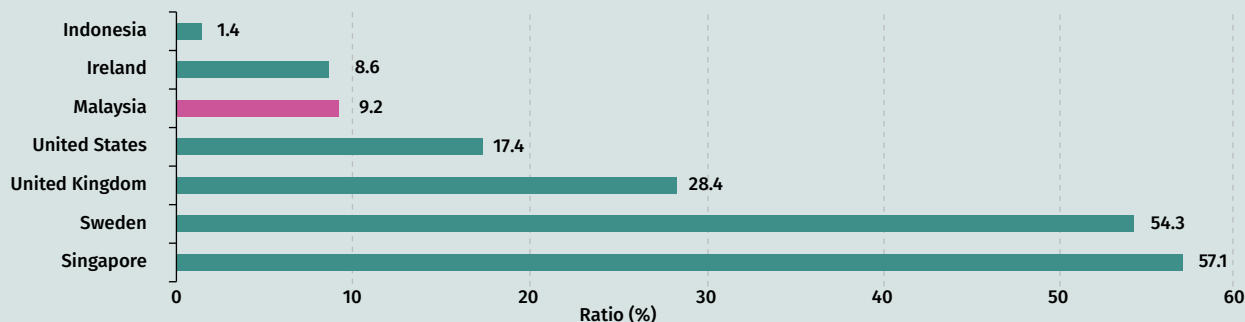
¹³ See footnote 1.

¹⁴ This reflects the significant portion of loans to purchase shophouses by households (57% share by value and 73% by number of accounts). Refer to the Chapter on 'Risk Developments and Assessment on Financial Stability' in the BNM Financial Stability and Payment Systems Report 2017 publication for details.

¹⁵ Refer to the Chapter on 'Financial Institution Soundness and Resilience' for further details.

Risks from broader contagion are also contained by the relatively small CRE market in Malaysia (Chart 3). Experience shows that foreign investors and cross border flows to CRE can amplify boom-bust cycles.¹⁶ However, the limited presence of foreign investors in the property sector in Malaysia (0.3% of total property transactions in 2020) reduces the likelihood of cross border investments amplifying contagion risk. Meanwhile, Malaysian real estate investment trusts (REITs), which are mostly funded by large institutional investors such as pension funds, remain a nascent and small market, representing less than 3% of total Bursa market capitalisation.¹⁷ While the larger¹⁸ REITs experienced sharp declines in income during the pandemic, the impact on financial institutions has been relatively muted given their limited holdings.

Chart 3: CRE Asset-to-GDP Ratio by Country



Note: Total CRE asset value is measured by the size of professionally-managed real estate investment estimated by MSCI Incorporated.

Source: MSCI Incorporated and Bank Negara Malaysia estimates

From the collateral channel, 4.5% of outstanding bank loans (excluding end-financing for the purchase of property) are secured by CRE. 92% of this are extended to businesses for working capital and construction purposes. About 186,000 units of commercial properties were used as collateral by businesses to secure loans totaling RM76 billion or 12.1% of outstanding bank loans to businesses. Businesses in the wholesale and retail trade sector make up a much higher proportion of such loans, with mainly shops owned by the borrowers being pledged as collateral. Credit risks from property-secured business loans are limited, as reflected by the low impairment ratio (2.3%), with the bulk (88%) of property-secured loans to businesses fully collateralised against the property value. Borrowers from the wholesale and retail trade sector who operate out of their own premises also have a strong incentive to meet their loan obligations in order to continue operating from the premise. Loans extended to households employed within the construction and real estate sector are also low at 7.7% of total banking system loans to households, thereby significantly mitigating risks arising from this channel. Importantly, financial stability risks from the CRE sector continue to be mitigated by prudent lending and provisioning standards that are observed by banks.¹⁹ This is further reinforced by strengthened prudential requirements applied to CRE lending. Notably, to finance development and construction projects, banks are expected to effectively manage risk concentrations and consider a broad range of factors when assessing the viability of projects. This includes demographic indicators (e.g., population and employment trends), as well as industry trends that could weigh on current and prospective lease terms, rental rates, and valuations.

While pre-existing issues of commercial property oversupply have so far not posed a significant risk to the financial system and broader economy, a sharp and protracted slowdown in CRE activity could have an indirect negative impact on other industries such as the manufacturing sector, ancillary business services (e.g., transportation, architectural, legal support, valuers, and property consultants) and wholesale trade providers. This could in turn affect employment prospects within these sectors and eventually weigh on the debt-servicing capacity among some households. As such, progress in resolving the existing glut, compounded by large incoming supply of office and retail spaces, remains important. More specifically, the long-term sustainability of the overall CRE sector will require stronger resolve and effort by industry players to re-strategise and, where needed, reform commercial spaces to take into account growing risks to prices and the structural shifts shaping demand.

¹⁶ See Aizenman and Jinjarak (2009).

¹⁷ Source: CEIC Data.

¹⁸ The top 5 REITs by market capitalisation experienced declines in income averaging 34% in 2021 compared to pre-pandemic income levels.

¹⁹ Refer to the Information Box on 'Banking Institutions' Provisioning Practices to Mitigate Elevated Credit Risk from the Pandemic' in the BNM Financial Stability Review for First Half 2021 for further details.

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